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ON THE ESCAPE OF FINANCIAL DISTRESS SITUATION: A REVIEW

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Abstract
Background: Financial distress has been an interesting topic to discuss in the last few decades. Many research was aimed to test the relationship of company's profitability and financial distress. Various variables including financial and non-financial variables as well as macroeconomic and microeconomic variables are used to predict financial distress. Various methods have also been applied to obtain financial distress prediction results with different levels of accuracy. However, directions on how to solve financial distress are still rarely discussed. Here, we bring discussion about financial distress resolution in the form of a light literature review.
Methods: This research is a qualitative-based study using a literature review approach which is developed to summarize and synthesize financial distress resolutions.
Results: Every country has their own procedures to solve financial distress. Whatever procedures that distressed companies take to cure the situation, it depends on how satisfactory the performance has been achieved, shown by the bankruptcy regime in facilitating the remedy process as expected in general. It also depends on how suitable the procedure is with the companies' conditions. Specifically, the likelihood of successful implementation of certain financial distress remedial efforts is determined both by the company as a debtor and the lenders as creditors.
Conclusion: Before companies decide to take on debt, they must first ensure that they have good cash flow and they are able to project the payment of interest and principal debt on time.

Introduction

Financial distress has been an interesting topic of discussions. A lot of research on predicting the probability of financial distress in companies has been conducted in the last few decades. Various variables both financial and non-financial as well as macro and microeconomic variables are used to predict financial distress. Not only that, various methods have also been applied to obtain financial distress prediction results with different levels of accuracy.

Brigham and Houston (2009: 87) stated that companies with financial distress usually start by paying debts more slowly so that they are trapped in a situation that forces them to borrow more from the bank, which in turn will increase their current liabilities. If current liabilities increase faster than current assets do, the current ratio will decrease and this is a sign of trouble.

Agrawal and Maheshwari (2014), Zaki *et al*. (2011), and Mselmi *et al*. (2017) stated that financial distress refers to the company's inability to pay its obligations on time. Meanwhile, Fabozzi and Drake (2009: 376) view financial distress as a condition in which companies make decisions under pressure to fulfill their legal obligations to creditors. This decision may not be in the best interest of the company owners. Based on these definitions, financial distress can be interpreted as a condition where the company's liquidity is disrupted.
Further, Fabozzi and Drake (2009: 393) explained that not all companies with financial distress will end up going bankrupt. Only extreme financial distress conditions can lead to bankruptcy.

Based on some of the definitions stated by economists about what financial distress is, we can understand that financial distress are only possible if the capital structure of a business unit contains debts. Besides, the cause of the financial distress can also come from external factors such as deteriorating macroeconomic conditions.

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We cannot deny that the existence of debts in companies' capital structure exposes companies to more risk than if they are fully funded with equity. But we also have to admit that debts can also have a positive impact on companies if they are managed properly.

There are two advantages that can be obtained by companies by taking debts. First, the use of debt lowers the tax bill and makes more of the companies' operating income available to their investors. Second, if the rate of return on assets exceeds the interest rate on debts, the companies can use debts to acquire assets, pay interest on debts, and have something left over as a bonus for shareholders. Thus, debts can increase the companies' return on equity.

For that reason, creative solutions to the negative consequences of the corporate indebtedness must be formulated to provide favorable mechanisms for rescuing viable businesses and result in sustainable and inclusive economic development (Nigam and Boughanmi, 2017).

Research on how companies get out of financial distress is still much less than research on the factors affecting financial distress to happen, whereas redemptions to avoid bankruptcy are the most important thing to do after the determinants of financial distress and the health status of companies are known.

The aim of this article is to review, summarize, and synthesize the redemptions to get out of financial distress situation and the factors that may contribute to invulnerability of companies suffering from financial distress.

Literature Review

Financial Distress

Companies' journey in developing their business is not always going easy. Sometimes companies encounter various kinds of obstacles both in terms of human resources, procurement of raw materials, marketing, and finance. Financial distress is one of the problems that may be experienced by companies of various business scales.

Several definitions of financial distress have been presented in the introductory chapter. The definition of financial distress is always associated with the company's inability to pay its debts on time. In relation to that, the company's ability to determine the composition of debt in the capital structure appropriately is crucial.

Brigham and Houston (418: 2009) explained that decisions in determining the capital structure involve a trade-off between risk and return. Using more debt will increase the risk for shareholders considering that they are the last parties entitled to a share of the proceeds from the liquidation of the company in the event of bankruptcy. However, using more debt generally increases the expected return on equity.

There is a greater risk associated with the use of more debt, that is downward trend in share prices. Thus, companies must find a capital structure formulation that can maintain a balance between risk and return so as to maximize share prices.

Determinants of Financial Distress

As previously stated, financial distress occurs as a consequence of taking on debt. Then, what does exactly cause companies suffering financial distress with this debt?

Lizal (2002) stated that there are three models that explain the causes of companies experiencing financial distress resulting in bankruptcy, they are: *neoclassical model, financial model, and corporate governance model*. According to the perspective of the neoclassical model, financial distress and bankruptcy are the results of circumstances that illustrate that the company has not been able to allocate assets appropriately. The financial model views that financial distress and bankruptcy are the result of a poor financial structure with liquidity constraints despite the right asset structure. Companies may be able to survive in the long term but they are in bankruptcy in the short term.

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As for the corporate governance model, views that the cause of financial distress and bankruptcy is poor management. In this case, if the company experiences prolonged financial distress, the owner of the company might consider replacing the previous manager with someone else who is considered more competent.

Models stated by Lizal (2002) above are all internal factors. Arnold (2013: 797) mentioned four risk factors for companies experiencing financial distress which are one of them has to do with macroeconomic factors. *First*, the sensitivity of company income to the level of economic activity in general. Prospective corporate creditors will assess if the company's revenue has a high level of sensitivity to the ups and downs of economic conditions. If creditors consider that the company has a large potential liquidation in the future due to predictions of a deteriorating economy, the creditors will demand a higher rate of return. In line with higher demand for returns, the potential for financial distress will also be higher as well. *Second*, the proportion of fixed costs to variable costs. Companies with high debt and very operationally oriented, are likely to face equity holders and creditors who demand high returns in accordance with high risks. *Third*, the level of liquidity and selling power of the company's assets. Companies with assets that are easy to sell at a high enough price if liquidated may prevent creditors or financial guarantee holders from demanding high-risk premiums. *Fourth*, ability to make money from business. Companies with high regular cash flow can increase the level of leverage higher than companies with erratic, highly uncertain, and delayed cash inflows.

The Cost of Financial Distress

Companies experiencing financial distress will eventually face many obstacles in providing products (goods or services) with the same quality when they are still "healthy". This condition has consequences for the company in the form of financial distress costs.

The cost of financial distress can take many forms, such as loss of potential sales (decreased revenue), difficulty in obtaining raw material supplies due to decreased supplier confidence, and being forced to meet creditors' demands to take on projects that provide quick returns, thus sacrificing projects with higher profits. with a longer period of time (Fabozzi dan Drake, 2009:394).

In assessing the effect of financial distress on firm value, management uses the present value of the expected cost of financial distress (Fabozzi and Drake, 2009: 396). The present value of the cost of financial distress depends on the possibility of financial distress, the greater the possibility of corporate financial distress, the greater the expected cost of financial distress.

They concluded that there are four factors affecting the present value of the company's financial distress costs, they are: (a) the likelihood of financial distress increases in line with the increase in business risk; (b) the likelihood of financial distress increases in line with the increase in financial risk; (c) limited responsibility increases the incentive for company owners to take greater business risks; and (d) the cost of bankruptcy increases the more the firm's value depends on intangible assets.

Research Methods

This research is a qualitative-based study using a literature review approach that was developed to summarize and synthesize financial distress resolutions phenomenon.

In order to carry out this extensive review, we use keywords: financial distress solution, financial distress resolution, resolving financial distress, and any other related words to cover related publications in management, finance, and economics from 2000 to 2020. Some other literatures found on internet are also reviewed for their contribution to related topics. Further, irrelevant articles such as non-English articles were excluded.

Results

How is financial distress solved?

Financial distress can be viewed as a double-step mechanism: first, the firm delays the repayments (or even does not repay) and second, the stakeholders trigger formal bankruptcy if they cannot (or do not wish to) privately renegotiate (Blazy et al., 2014). Previous research has highlighted the resolution of financial distress from several perspectives. Nigam and Boughanmi (2017) stated that every country has two procedures to resolve financial distress: formal procedures (through the courts) and private workout (out of the court settlements).

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Formal procedures usually refer to filing for bankruptcy by creditors or debtors themselves, while private workout usually refers to reorganization efforts.

Like Nigam and Boughanmi (2017), Blazy et al. (2014) stated that there are two ways to resolve financial distress: the creditors privately renegotiate with the debtor (reorganization) or taking a formal bankruptcy procedure (liquidation).

Nigam and Boughanmi (2017) highlighted the strengths and weaknesses of court and out-of-court procedures. They also analyzed the reasons why companies chose one of two ways available. They stated that formal bankruptcy procedures involve direct costs and indirect costs. Direct costs can be in the form of fees to lawyers, auditors, accountants, and other professional fees; while indirect costs can be in the form of lost investment opportunities, lost sales, loss of competitiveness, costs arising due to suboptimal use of existing resources, loss of management time, asymmetric information, and conflicts of interests. These costs can eventually shrink the overall incentives of the claimants.

Some pervious researchers argued that out-of-court settlements are more cost efficient than formal processes although measuring the direct costs of informal workouts is not easy. However, some of them have been able to document these costs for the restructuring of public debt via a formal exchange offer. The out-of-court settlements are proven to be faster than the very time-consuming judicial process associated with legal proceedings that included a myriad of complex multilevel interactions, information exchange, and creditor approval. Moreover, if the companies can do private workouts well through debt restructuring in their capital structure, they will be successfully resolving financial distress and avoiding bankruptcy costs. However, the companies' efforts to maintain the confidentiality of financial distress in order to maintain creditors' trust and a good reputation in the market and in public will not be a piece of cake.

Bris et al. (2006) in their research on the bankruptcy of small and large companies (public and private companies) in Arizona and New York from 1995 to 2001 found that the implementation of Chapter 7 of the United States Bankruptcy Code (liquidation) was no faster or cheaper than the implementation of Chapter 11 (reorganization), particularly after they control for endogenous self-selection of firms into bankruptcy procedure.

Pustylnick (2012) also explained that legal costs in the latter can exceed perceived benefits so he argued that the best solution for negative NPV and negative cash flow problems (as a symptom of project distress) are deferring of payments and restructuring of cash disbursements.

Apart from the aforementioned studies on formal and informal procedures for resolving financial distress, we find a unique empirical study by Armour and Deakin (2001). They researched on how an informal set of market norms known as "London Approach" was used to resolve financial distress amongst creditors of large UK firms given that the UK is a country with corporate insolvency law which was strongly oriented towards the protection of creditors' rights (secured creditors in particular). With this London Approach, viable distressed companies had the opportunity to carry out restructuring secretly which was assisted by Bank of England as a negotiation facilitator rather than directly enforcing insolvency laws that tend to favor creditors. At the end, many companies were helped and able to get out of financial distress so that the rules and principles that became the framework for London Approach were legalized in standard contracts and other legal instruments that were widely used in the financial sector in London. Unfortunately, since the recession in the early 1990s, globalization, the more frequent use of disintermedied debt financing, and syndicated bank loans developed in London had profoundly destabilized consequences for the norms which had "regulated" the London Approach in the past.

Determinants of Strategies Companies Choose to Solve Financial Distress

There are only two options in general that companies have to resolve financial distress: formal procedures (through the courts) and private workout. However, there is a wide range of how companies put this resolution into practice. There are many factors, of course, that influence the way companies resolving financial distress. This section will discuss the factors behind the companies' decision in taking certain strategies or actions to resolve financial distress.

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Blazy et al. (2014) examined the factors influencing the determinants of arbitration between 386 distressed companies in France (excluding agricultural and financial companies) and creditors in resolving financial distress. They found that bargaining power imbalances between companies (debtors) and creditors had a significant effect on the determination of arbitration, especially when the bank was the main creditor. Whatever the coordination problem is, large banks tend not to be interested in renegotiating because (1) competition with other minor creditors is very weak (in this case the banks feel that they do not benefit from postponing the settlement of cases through this type of arbitration which takes a lot of time); and (2) the survival of debtors highly depend on the main bank's financial support, so that the outcome of bankruptcy will likely be what the banks desire. This is also in line with the findings of Franks and Sussman (2000), except that they added that the banks' liquidation decision is not done just like that but it is related to the companies' willingness to restructure and replace its own management.

However, there are things other than bargaining power imbalances that can lead to the probability of renegotiation, they are the amount of debt at stake and the length of the debt contract. The bigger amounts at stake or the longer debt contracts are , the higher chance of undertaking renegotiation will happen regardless of the success or failure of the renegotiation process. This is in line with what Nigam and Boughanmi (2017) stated that the costs of liquidation process can eventually shrink the overall incentives of the claimants so the banks considered possible renegotiation rather than risking a large amount of loss.

In the previous year, John et al. (2013) revealed the reasons behind the companies' decision to resolve financial distress between two options: Chapter 11 reorganization and workouts (private restructuring). They stated that the choice of the mode of reorganization depends on three things: the liquidity of firms' assets, the indirect cost of financial distress (represented by the value lost from delayed investment), and the privately known quality of the investment opportunities.

Companies with poor quality investment opportunities, regardless of liquidity characteristics of the assets, tend to preserve the option value of equity by filing for Chapter 11. Given the associated preservation of equity value and the debtors' bargaining power, inefficient firms prefer to choose formal procedures (through the courts) rather than to take a private restructuring (Hotchkiss et al., 2008). Whilst, companies with good quality investment opportunities and highly liquid assets will prefer private restructuring to Chapter 11 reorganization.

Goto and Uchida (2011) found that one of the factors that affect the successful resolution of financial distress through private restructuring is the higher composition of unsecured bank loans. If the private restructuring is successful, holdouts are paid according to the original debt contract and the cost of restructurisation is entirely borne by the bondholders who participated in the process and accepted a reduction of their claim value (Hotchkiss et al., 2008).

However, the restructuring choice came up with a complication. The redistribution of financial claims on the distressed firms may not be independent of the firms' asset restructuring decisions. Different claimholders may have conflicting incentives as to the investment decisions for a highly leveraged distressed firms. The issue is that value of senior claims decreases with risk, while the value of junior claims increases with the riskiness of the firms' assets. A conflict, at the extreme, can arise as to whether to reorganize or liquidate the firm. First of all, before companies make the reorganization decision, they compare the benefits of assets liquidation and workouts with the benefits of Chapter 11 filing and new claims issuance.

Koh et al. (2015) described in detail how companies' life cycles affect the strategies taken to resolve financial distress (as we know that there are four companies' life cycles: birth, growth, maturity, and decline) and how they affect the likelihood of recovery. Some strategies are only suitable for financial distress conditions at a certain life cycle. For example, distressed companies at the birth stage tend to resolve financial distress by reducing the cost of goods sold (COGS) and laying off employees instead of managerial restructuring because at the birth stage, companies have highly centralized power structures where, often, the managers are also the owners that make them impossible to take managerial restructuring action. There are also strategies that work for all distressed companies at any stages of life cycle associated with high recovery opportunities, they are reduced investment and reduced dividends.

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Conclussion

Every country has their own procedures to solve financial distress, whether it is formal or informal way. Whatever procedures that distressed companies take to fix up the situation, it depends on how satisfactory the performance shown by the bankruptcy regime in facilitating the remedy process as expected in general, and depends on how suitable the procedure is with the companies' conditions and the likelihood of successful implementation of certain financial distress settlement efforts determined by the company as a debtor and by the lenders as creditors, more specifically.

Based on what is described above, no matter how good the companies' efforts to resolve financial distress, it is still better to take preventive measures so that the company does not experience financial distress. It is important to highlight that before companies decide to take on debt, they must first ensure that they have good cash flow and they are able to project the payment of interest and principal debt on time, or in other words adjust to their needs and ability to pay off and take into account the risk of financial distress in the future with plans to resolve it if it does occur.

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